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UNCLAS SECTION 01 OF 03 NAIROBI 002691

SIPDIS

SENSITIVE

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TREASURY FOR ANN ALIKONIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV EAID KMCA KE
SUBJECT: KENYA'S BUDGET: MORE SPENDING, BUT BETTER FOCUSED ON DEVELOMENT NEEDS

REF: A) NAIROBI 2651, B) NAIROBI 1756

Sensitive-but-unclassified. Not for release outside USG channels.

¶1. (U) This is a joint State-USAID cable

¶2. (SBU) Summary: Kenya's new budget for the fiscal year beginning July 1 foresees a 34% nominal increase in spending, but proposes to spend proportionally more money in areas deemed crucial to economic development and poverty reduction, namely health and infrastructure. Estimated revenues will fall short of total spending, producing a budget deficit of around $2.4 billion. However, budget planners prudently excluded anticipated (but not firm) revenues from donor projects; should these come on line later in the year, they would represent a budget windfall. The new budget is a positive step forward both in terms of an improved planning process, and in the resulting incremental realignment of spending towards priority areas. But the trick to making it really work will be in the implementation. End Summary.

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## BUDGET BY THE NUMBERS
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¶3. (U) Kenya's budget for FY 2005-06 (which begins July 1) was presented to Parliament June 8 by Finance Minister David Mwiraria. The budget as presented forecasts a record KSh 508.5 billion ($6.6 billion) in total spending, a nominal increase of 18% over the revised budget estimates for the fiscal year ending June 30. On the other side of the ledger, total revenues will reach KSh 326 billion ($4.3 billion), a 10.5% increase over the latest estimates for revenue collection in the current fiscal year. This leaves a deficit before grants of KSh 182.5 billion ($2.4 billion), which is more than a third larger than the deficit forecast for the present fiscal year.

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## SPENDING MORE ON DEVELOPMENT AND POVERTY REDUCTION
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¶4. (U) In keeping with the theme of the budget speech - "Reorienting Expenditure to Achieve Rapid Economic Growth and Poverty Reduction" - the budget boosts development spending by 45% to KSh 104.2 billion ($1.4 billion). Recurrent spending, on the other hand, grew a more modest 25%, while still constituting just under 80% of total expenditure. Development spending still lags with a 20% share of total spending, but this is up from 17% last year.

¶5. (U) Along the same lines, those ministries deemed essential to poverty reduction and economic development get bigger budget increases this year, driven in large part by large increases in their development budgets. Budget standouts include:

-- Health: Total allocation up 37.2%; development budget up 123%; total share of spending up to 5.9% from 5.1% last year.

-- Roads and Public Works: Total allocation up 47.3%; development budget up 95%; total share of spending up to 5.6% from 4.5% last year.

-- Water and Irrigation: Total allocation up 57%; development budget up 82.3%; total share of spending up to 2% from 1.2% last year.

¶6. (U) Education saw its budget allocation rise by 14%, or by less than the increase in overall spending. But the Education Ministry already dwarfs all others in total spending, with a 19% share of the budget, essentially flat from last year. Its development allocation increased by 43%, however, while budgeted recurrent expenditures rose by only 12%.

¶7. (U) Nearly all ministerial and agency line items in the new budget received larger allocations this year, reflecting that fact that spending is nearly a third higher than last year across-the-board. The Office of the President (OP) and the Defense Ministry, for example, are big spenders generally, taking up nearly 7% and 5.5% of all spending respectively. The OP budget is larger than last year, but grows by only 6.8%. Defense is up 25%, which is still less than the increase in overall spending. These increases, however, have still generated criticism and debate in both Parliament and the press over whether the government is providing enough resources to core poverty reduction programs, despite the big increases in health, infrastructure, and education.

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REVENUES AND FINANCING THE DEFICIT
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¶8. (U) The Kenya Revenue Authority (KRA) outdid itself during the past fiscal year, raking in KSh 293.4 billion ($3.8 billion), 13% more than originally anticipated. Recognizing that some of last year's growth came from one-time-only gains, including a tax amnesty, the new budget anticipates only a 10.5% increase in revenue over last year, not enough to balance the budget. The Finance Minister plans to plug the $2.4 billion budget gap through external assistance in the form of grants ($372 million), new external borrowing ($514 million), privatization proceeds and bank restructuring proceeds ($220 million), other items ($1.1 billion), finally, new domestic borrowing of KSh 25.4 billion ($338 million).

¶9. (U) As such, the budget as presented foresees a substantial increase in the stock of domestic debt. However, in drafting the budget, the Finance Ministry consciously exercised fiscal prudence by including only firm commitments from donors, and excluding conditional offers of assistance. As such, should the government meet the conditions for upcoming World Bank and bilateral credits and grants during the course of the year, the revenue will constitute a windfall which can be used to increase spending in priority areas, or to reduce domestic borrowing.

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TAX AND TARIFF CHANGES
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¶10. (U) In keeping with the "pro-poor" budget theme, Mwiraria also announced a number of tax changes designed to lower living costs for the poor. Some of the highlights include:

-- Tariffs on imported used hand clothing will drop to 45% of ad valorem or $0.30 per kilo (from 70% or $0.60 per kilo previously).

-- Tariffs on imported pharmaceuticals will return to being zero rated after being raised to 20% on January 1 upon formation of the East Africa Customs Union.

-- Tariffs on diapers, sanitary pads, cooking gas, coal and media containing software zero rated.

-- VAT on sanitary towels, LPG, maize flour, milk and kerosene all zero-rated.

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COMMENT
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¶11. (SBU) The new budget is good news in two respects: first, the process by which it was formulated was a big improvement over past practice (see ref B) in terms of discipline, transparency and buy-in from line ministries. Second, and in large part as a result of improved budget planning, the content of the budget has succeeded in more closely aligning planned spending with areas considered priorities under the country's economic development blueprint, the Economic Development Strategy. An IMF team visited Kenya just after the budget was presented, and has incorporated it "lock, stock and barrel" into the performance criteria for the next review period under Kenya's IMF program. The World Bank commented at a recent donor coordination meeting that the new budget represented a "huge move forward" both in terms of process and results, and noted that Kenya is likely to realize unbudgeted revenues from donors which the Bank is confident will be used to fund priority development projects.
¶12. (SBU) The trick, however, will be in implementation, especially at the line ministry level, where past practice has shown wide divergences between the budget forecast and the actual outturn, both in terms of overspending in some areas and under-spending in others (ref B again). The

Roads Ministry, for example, is slated to receive another major boost in funding this year to build roads. This is fully justified given the urgent need for better roads in Kenya as a way to maintain and accelerate economic growth. However, because of human capacity constraints and cumbersome procurement processes, the Ministry last year spent less than half the funds allocated to it for this purpose. Typically, ministries less involved in providing critical services and infrastructure (e.g. the Office of the President) overspend their allotments. In short the Finance Ministry, which deserves the lion's share of the credit for improving the budget process, still has its work cut out for it in terms of ensuring discipline as the budget moves from being just a plan to being money actually spent.

¶13. (SBU) Along these same lines, we note that a number of commentators have asserted that Kenya's new budget lacks full transparency in terms of destination and use of allocated monies. This is nothing new, but unlike in past budgets, when which particular budget lines were specified, the new system of printed estimates is devoid of details of where and how the money is to be spent. While these changes have been introduced to improve pipeline management and facilitate shift from one ministerial line item to another in case of either slow disbursement or emergency, the fact that the actual disbursement decisions will be left to individual ministers raises the specter of political manipulation by ministers (who are sitting MPs) in the run-up to the 2007 general elections. Also, under the current system, tracking of expenditures can only be implicitly inferred from budget lines leaving wide scope for possible financial impropriety and mismanagement. Again, this in many ways is nothing new, and serves as a reminder that the ultimate success of the budget will be more in the implementation than in the planning.
BELLAMY